E-002/M-90-1159 ORDER APPROVING PROPOSAL AND REQUIRING FURTHER FILINGS

BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

Darrel L. Peterson	Chair
Cynthia A. Kitlinski	Commissioner
Dee Knaak	Commissioner
Norma McKanna	Commissioner
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In the Matter of the Proposal of Northern States Power Company's Electric Utility for a Demand-Side Management Incentive Mechanism

ISSUE DATE: March 19, 1991

DOCKET NO. E-002/M-90-1159

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PROCEDURAL HISTORY

On December 18, 1990, Northern States Power Company (NSP or the Company) filed a proposal for an experimental demand-side management (DSM) incentive mechanism. The proposal combined a bonus return on rate base concept with a strategy for compensating the Company for lost margins due to load management.

On December 21, 1990, the Commission issued a Notice of Comment and Reply Period. Seven parties submitted written comments in response to the Notice.

The Department of Public Service (the Department) and the Residential Utilities Division of the Office of Attorney General (RUD-OAG) filed comments in support of NSP's proposal on January 14, 1991. On January 14, 1991 and January 17, 1991, Minnesota Power and Otter Tail Power Company respectively submitted comments recommending that the Commission approve NSP's demand- side incentives while keeping the basic concept flexible. In comments dated January 14, 1991, North Star Steel Company (NSS) urged the Commission to defer consideration of NSP's proposal to the 1991 NSP rate case. Minnesotans for an Energy Efficient Economy (ME3), a coalition of energy conservation providers, community groups, religious organizations, and other entities, filed comments which supported NSP's proposal, if a performance-basis mechanism and other improvements were added. On January 14, 1991, Minnesota Energy Consumers (MEC), a group of industrial NSP customers, urged the Commission to reject NSP's proposal.

The Commission met on February 21, 1991, to consider NSP's demand-side management proposal.

FINDINGS AND CONCLUSIONS

The Company Proposal

NSP's demand-side management proposal contained the following elements:

1. The Company would continue to account for approved Conservation Improvement Program (CIP) load management and conservation projects through the existing cost recovery mechanism (the CIP debit account, or tracker);

2. Expenditures due to NSP's direct impact CIP projects (essentially, all projects except research and load management) would be capitalized and amortized over a five-year period;

3. The rate of return applied to the unamortized portion of the capitalized expenditures would include a 5% bonus return on equity, adjusted to consider tax effects;

4. Research and load management expenditures would continue to be expensed in the year incurred;

5. NSP would recover one-half of any interruptible rate discounts the Company offered which fell above levels built into the 1991 test year.

The Company estimated that approximately 77%, or $11.8 million of its CIP budget, would be eligible for the rate base bonus and the remaining 23%, or $3.6 million, would be expensed as load management and research costs. The Company's estimate was based upon its 1991 CIP budget currently under consideration by the Department.

Commission Authority

In a separate docket, the Commission previously initiated an investigation into the use of financial DSM incentives. In the Matter of a Summary Investigation into Financial Incentives for Encouraging Demand-Side Resource Options for Minnesota Electric Utilities and Bidding Systems, Docket No. E-999/CI-89-212, ORDER INITIATING PROCEEDING AND SOLICITING PROPOSALS AND COMMENTS, (May 23, 1989). In the 212 docket, the Commission determined that it has broad authority to approve financial DSM incentives under Minn. Stat. § 216B.03, which states in part: "To the maximum reasonable extent, the commission shall set rates to encourage energy conservation and renewable energy use..."

MEC challenged the Commission's authority to approve DSM incentives, based upon MEC's reading of Minn. Stat. § 216B.16, subd 6. This statute requires the Commission to determine just and reasonable rates while allowing the utility to "...earn a fair and reasonable return upon the investment in [its] property." MEC contended that a bonus return on equity would exceed a fair and reasonable return for the Company.

The Commission finds that Minn. Stat. § 216B.16, subd. 6 does not preclude Commission authority to approve DSM incentives. The Commission recognizes financial needs of both utility ratepayers and shareholders. Because of these needs, a 5% bonus on capitalized conservation expenditures can be a just and reasonable means of encouraging present expenditures to achieve long-term conservation goals. Approving such a plan would be within Commission authority.

Demand-Side Management

Demand-side management is a method of adjusting energy production and consumption by means of conservation measures and load management techniques. Under current ratemaking procedure, there are natural disincentives to reduction of energy consumption or capacity needs through demand-side management. Utility rates are set in a manner which encourages utilities to increase sales between rate cases. Utilities lose their margin (profit and contribution to fixed costs) on units of energy which are conserved rather than sold. Utilities are also discouraged from demand-side investment by the fact that supply-side investments earn a rate of return on rate base while demand-side investments do not.

The benefits of utility investment in demand-side resources are many. Demand-side investment directly lowers utility bills for participating customers. All ratepayers benefit from lower rates due to deferral or avoidance of costly supply side capacity investments. Demand-side management methods can foster national energy self-sufficiency and help combat acid rain and global warming.

Recently there has been considerable national and state level attention to incentives for utility investment in conservation. Energy experts have increasingly advocated combining financial incentives with statutory conservation mandates such as the CIP program. The National Association of Utility Regulatory Commissioners (NARUC) recently adopted a resolution urging state commissions to consider and use incentives for electric least-cost utility planning. NARUC specifically urged commissions to consider the loss of earnings potential associated with DSM resources.

NSP's Proposal for Amortization of Conservation Expenditures

NSP's proposal would allow the Company to capitalize certain conservation expenditures and earn a return on them, with a bonus rate of return on equity applied to the unamortized portion. The Commission finds that NSP's proposed plan is a logical first step toward removing disincentives from demand-side management techniques. The plan would put demand-side expenditures on an equal footing with supply-side expenditures. This accounting equality is logical, since demand-side expenditures are really a substitute for less clearly beneficial supply-side expenditures.

Although the Commission shares the concerns raised by MEC regarding the possibility of "gold-plating," the Commission finds that this concern is answered by the CIP mechanism. "Gold-plating" is the practice of investing in the most expensive, least efficient DSM so that the Company could earn a return on its DSM expenditures yet maintain sales levels. The Commission finds that the close scrutiny afforded all CIP programs by the Department will preclude wasteful, cost-inefficient programs. NSP's total conservation effort, including its efficiency, is also reviewed by the Commission in the resource planning process.

Some commenting parties questioned the wisdom of applying a 5% bonus return on unamortized DSM expenditures. The Commission finds that in the absence of a DSM "track record," 5% is an appropriate figure to utilize. This bonus is high enough to provide a measurable incentive for DSM investment, yet not so high that the Company is unduly rewarded. As the DSM mechanism is reviewed in the future by the Department and Commission, it will be possible for the Commission to adjust the percentage by further Commission Order.

In their comments, NSS and MEC urged the Commission to shift consideration of NSP's proposal to the Company's current rate case. The Commission finds that it is right and logical to consider the proposal at this time. In the 212 investigation docket, the Commission has clearly stated that DSM methods should be explored and implemented by utilities. NSP has proposed a plan which appears workable. Although the plan is not perfect (most notably, it lacks a performance-basis mechanism, as discussed below), it is a good first effort towards removing financial disincentives to DSM methods. The Commission will approve the Company's DSM incentive proposal.

NSP's Proposal for Recovery of Lost Revenues

NSP proposed a program whereby it would recover 50% of the portion of interruptible rate discounts it offered which fell above levels built into the 1991 test year. The Company would thus be compensated for lost margins which had not been figured into test year forecasting. By addressing short-term revenue losses between rate cases, a disincentive to interruptible discounts would be removed.

NSP's interruptible rate recovery proposal is a load management stratagem rather than a pure conservation measure. Load would be shifted to avoid or defer addition to capacity which would otherwise be necessary.

NSS objected that financial incentives should not be applied to regulate capacity needs rather than to conserve energy. The Commission finds that avoidance or deferral of capacity expansion is a worthy goal which is clearly in the public interest. The Commission also finds that NSP's recovery of lost revenue proposal is not a pure incentive. Rather, a disincentive for use of interruptible rates is removed when the Company is allowed to address short-term revenue losses swiftly, without waiting until a future rate case.

Like NSP's bonus return on rate base proposal, this load management proposal is on the cutting edge of DSM development. NSP's program is experimental; time and experience may indicate that changes should be made. The Commission finds, however, that the Company's present proposal is clear, logical, and workable, and will aid NSP in its load management goals. The Commission will approve NSP's recovery of lost revenue proposal.

Performance-Basis Mechanism

NSP's proposal did not contain a performance-basis mechanism which would link Company reward to a reduction in energy use or deferral or avoidance of capacity addition. All parties, including NSP and the state agencies, recognize that such a mechanism is desirable. The parties have agreed to discuss the implementation of a performance-basis mechanism and to return to the Commission with a proposed plan within 90 days of the Commission Order.

The Commission understands and shares the concerns expressed by many parties regarding the lack of a performance mechanism. The Commission recognizes that such a mechanism would remove or reduce many legitimate concerns, including the issue of "gold-plating." The Commission finds, however, that there are sufficient safeguards within the present system, including review of CIP proposals and the resource planning process, to warrant present approval of the NSP plan. The Commission will, however, require that the parties work together and submit a proposed performance mechanism within 90 days, as they have agreed. In light of this upcoming contribution, the Commission will approve the Company's DSM incentives proposal.

Evaluation

Because NSP's proposal is in the forefront of relatively new DSM theory, the Commission will require that the Company submit evaluations of the proposal as implemented. NSP will be required to file an evaluation plan within 90 days of the present Order, as well as an annual report on the plan.

Cost Recovery

As previously stated, the Commission does not believe that it is necessary to defer consideration of the Company's financial incentive plan until the Company's next rate case. The benefits of this type of plan are so well established that the Commission does not wish to delay implementing the Company's plan. The Commission does realize, however, that there will be legitimate questions raised regarding methods of cost recovery arising from the Company's plan. The Commission will require that these issues shall be addressed in the Company's 1991 rate case, Docket No. E-002/GR-91-001.

Conclusion

With help from the RUD-OAG and the Department, NSP has drafted a plan which will begin removing disincentives to conservation and capacity regulation through the use of rate base recovery and lost revenue recovery theory. The Commission appreciates the comments of the parties, who are all struggling to bring demand-side management incentive theory into a practical plan.

The Commission recognizes that NSP's plan is experimental and will require evaluation and monitoring. The Commission finds that it is an appropriate first step towards using demand-side management to achieve goals all parties share, fair and reasonable rates and responsible energy use.

ORDER

1. NSP's proposed demand-side management incentive mechanism is approved.

2. Within 90 days of the date of this Order, NSP shall file a performance-basis mechanism to be integrated with the incentive mechanism approved herein. To arrive at this component, NSP shall work with the Department and any other parties to this docket who wish to contribute to the discussion.

3. Within 90 days of the date of this Order, NSP shall file a plan for evaluating the incentive program.

4. NSP shall file an annual report on the incentive mechanism. The annual report may be included in the Company's annual CIP tracker report.

5. Issues of cost recovery stemming from the Company's demand-side management incentive mechanism shall be addressed in the Company's current rate filing, Docket No. E-002/GR-91-001.

6. This Order shall become effective immediately.

BY ORDER OF THE COMMISSION

Richard R. Lancaster
Executive Secretary

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